RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

P. O. Box 1759, La Jolla, California 92038
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August 13, 1980 **LETTER 789**

Aug. 1, DJIA 931.38; PTI 1276; A-D Ratio –17.01
Aug. 8, DJIA 954.69; PTI 1289; A-D Ratio –16.52

THE PICTURE: Pity the poor market letter writer. In any other business, when you make a mistake you can lie your way or wheedle your way out of it. But the advisor puts his opinions down in writing, so when he's wrong everyone knows about it - either through written evidence or (even worse) via tattered bank accounts!

Thus, the need for humility in this business. The best of the Wall Street writers have learned (through hard experience) to bow low to the markets. They wrestle with the markets, wring their hands over the markets, scrutinize the markets - but they never argue with the markets.

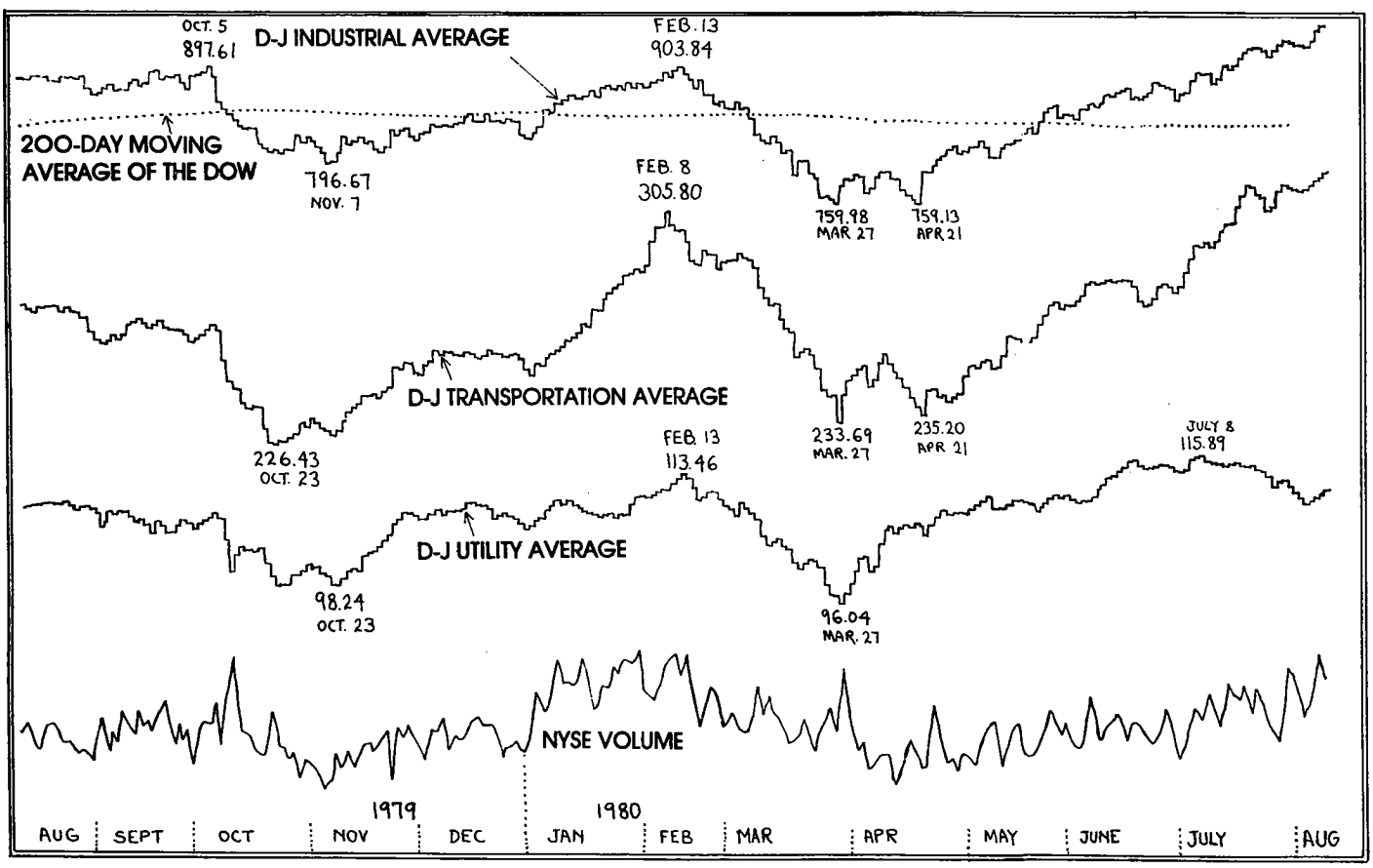
Over the last few months I have been watching one advisor as he commanded his readers to "load up" on long-term bonds ("yields on long-terms are going down to 8% by year-end"). Then he got caught in the recent bond market swoon, and doubtless his followers were horribly mangled. What was his answer to this mini-disaster? He wrote, "Take your profits and await a better buying opportunity." He may not have any subscribers left, I mused to myself, but this guy has plenty of moxie!

How do things look in the US? To put it mildly, conditions are "unsettled." On the political front, President Carter's ratings resemble a chart of Chrysler's earnings, and Democrats across the board are wondering whether they should run with or without the Carter endorsement. On the other hand, Ronald Reagan never looked better. But as far as I am concerned, a Republican candidate is never a sure thing in these Democratic United States.

On the economic front, inflation is still the number one story, but the number two story is disinflation in oil prices. With oil literally coming out of our ears, even the price of gas is now subject to trade wars. Biggest economic worry was described by Morgan Stanley's brilliant Barton Biggs (WSJ July 4). Biggs is thinking that maybe the world is about to switch "from stagflation to synchronized world recession" (with the US recovering a bit, then "double-dipping" into a renewal of the recession).

Meanwhile, the recession statistics continue to pour out. But S.J. Levy, one of the nation's most accurate analysts, believes that by the fourth quarter of this year, business will be picking up again—along with inflation.

I follow the various markets carefully, and this is what I've seen over the past few weeks to months. (1) The dollar has turned strong. (2) Interest rates are pushing higher. (3) Bonds and money instruments are turning weak. (4) The stock market has been continuing its extraordinary advance, with most of the major composite stock indices pushing to historic highs. (5) The commodities are strong, but this may be due to unbelievably rotten weather conditions. (6) Gold and silver are still recovering from the January-March smash, but gold having established a strong base at 500, now appears to be doing the same with 600.

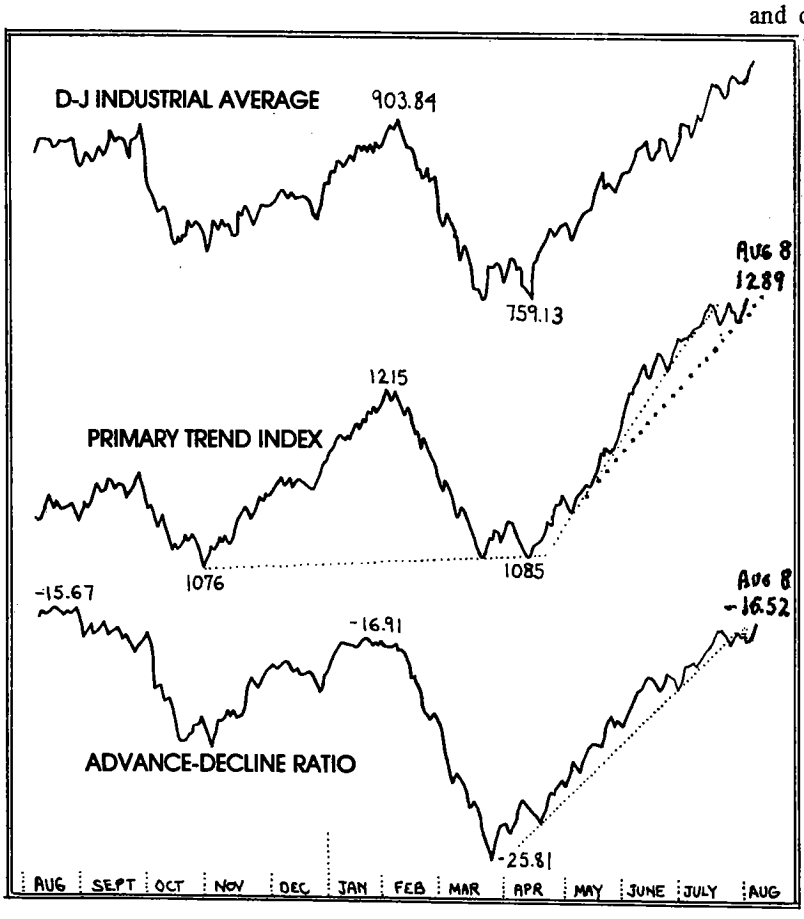


(7) The collectibles markets (stamps, coins, antiques, art), which are very sensitive to inflation, appear to be firming up and 1980 has seen no dearth of world record prices in various categories. World stock markets are, for the most part, in bull trends with new historic highs in New York, Japan, Hong Kong, Australia, Singapore, S. Africa. Only West Germany, Holland, Sweden and Switzerland are lagging.

Now let's turn to the page 1 daily chart of the D-J Averages. What we see here is nothing short of high drama. Last week (week ending August 8) saw the Industrial Average close at 954.69, its highest level since 1977. On the same day the Transportation Average closed at 316.17, an all-time record high. That a series of Dow Theory bull signals has been flashed by the two Averages is clear. But what is even more stunning is that these signals have come with 64 million shorts (a record number!) positioned on the WRONG side of the market. Thus what we have been seeing is a powerful primary up-trend with the largest bear (short interest) interest in Wall Street history being pressed to the wall.

This extraordinary phenomenon is producing some of the most explosive action seen in the stock market in many a year. For instance, the broad NYSE Composite, an index including all NYSE common stocks, has closed higher for 14 out of the last 17 weeks. This is a string that has had few equals in the annals of Wall Street.

Nothing in the market technical syndrome is perfect, and today's action is no exception. As you can see on the page 2 chart, the action of the D-J Utility Average has been counter to that of the Industrials and Transports, with Utilities trending down ever since July 8. The Utilities have been joined by the D-J 20-Bond Average, and as veteran readers of these Letters know, a joint declining trend in both Utilities and Bonds has always been one of my signals of increasing danger for the stock market.



Whether or how this potential danger may strike no one can say at this time. With Industrials and Transports hitting almost daily highs, with the shorts in a state of panic, the market is set up for what I have termed "the spike."

It is perhaps no coincidence that high on the list of best selling books in the US is one called "The Spike." This book deals with the process of "spiking a story" or killing a story, a process by which an editor impales a story by spearing it on a spiked object which sits atop his desk. The spike on Wall Street will often kill a market movement, but let me explain further.

At last week's Beverly Hills investment seminar conducted by the American Economic Council, I termed the 1980 market the "era of the spike." This spike action is a product of violent markets, markets that have been generated by rapid shifts of huge amounts of US and international money. Look at what we've seen so far in 1980. A rush in the gold and silver markets to spike tops in January, then a twin-slump to the March lows. We've seen interest rates spike up to all-time record highs, then smash down as dramatically as they rose. We've seen spear-point moves in many of the commodity grains, and it is probable that these commodity spikes are still in the formative stage.

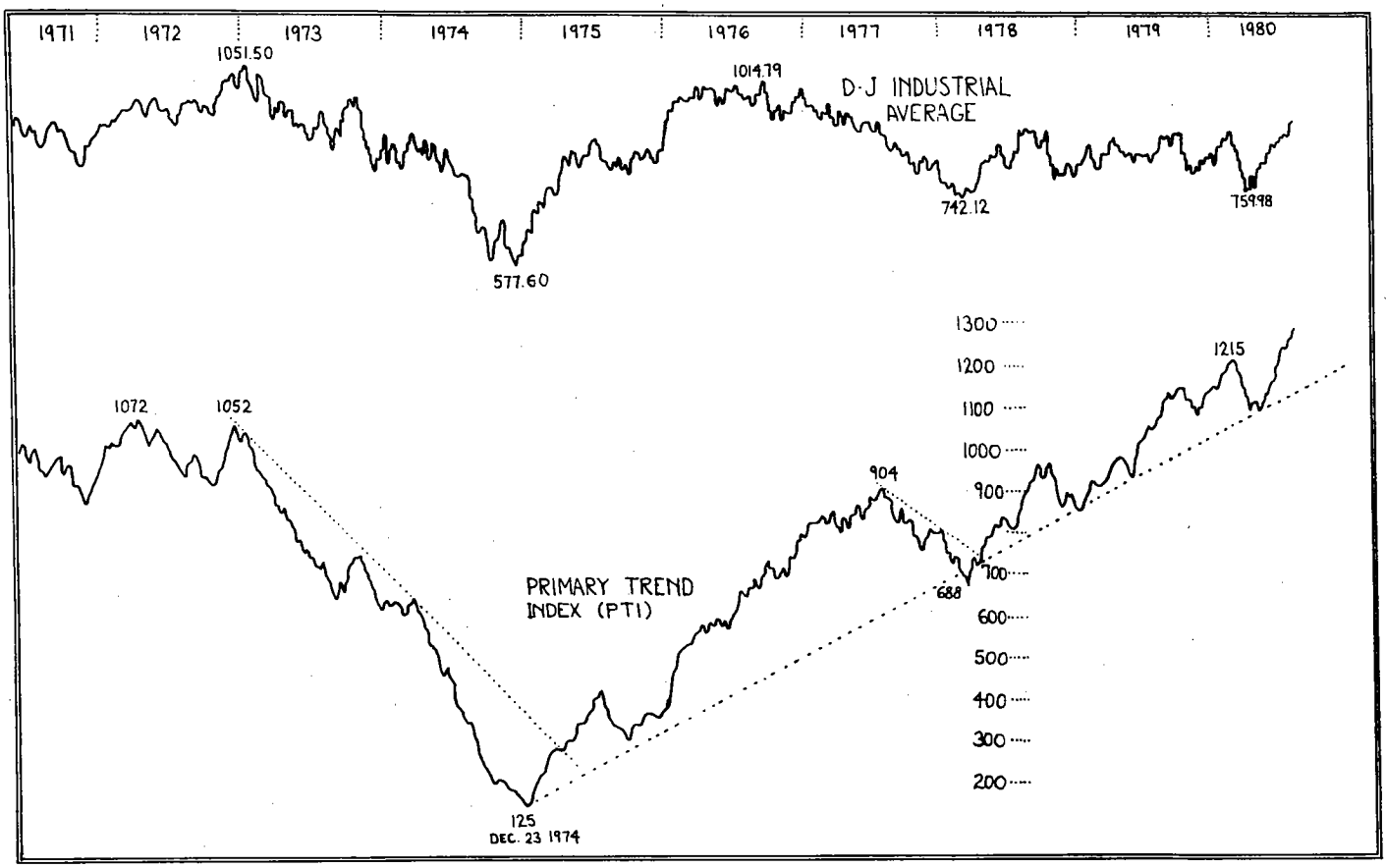
Now we see the stock market (this is clearly seen on an arithmetic chart) spiking higher and higher. The explosive upside action is being spurred on by an excruciating short squeeze, even while the odd-lotters cut back sharply on their selling (negative for the market), and even while bonds and utilities sink to lower levels (a classic signal for caution). Thus, the stock market is taking its turn to spike. It promises, as I said, to be a year of high drama!

The Primary Trend Index (as explained in the last Letter) formed a little double top at the 1284 level (see chart below). This occurred following a breaking of the March-July rising trendline, and that break could have been the first hint of trouble for the market. But there was no downside follow-through in the PTI, and on August 8 the PTI ended the week at 1289, the highest figure of which I have any record since I first started plotting the PTI in 1971. Thus, the PTI continues to tell us that the primary trend of the market is up, and it tells us that the possibility for danger which was hinted at in the little July double top has now been flushed away by new highs. I have drawn a second trendline under the PTI which contains the latest action.

As you can see on the chart at left, the daily advance-decline ratio on August 8 rose to minus 16.52, its highest level in 1980–but still about a point short of confirming the whole picture, since the A-D ratio is still below minus 15.67, the high level for 1979.

As I have been pointing out in recent Letters (see the chart in Letter 788, page 3), the market is now within a week or so of the theoretical peak in the 233-day cycle. From mid-August to late-October, the bearish segment of the cycle holds sway. How the market conducts itself during this period promises to be fascinating, and it will be crucial to me in my appraisal of the overall picture.

With the 233-day cycle turning down, with the odd-lotters cutting back on their selling, with bonds and utilities drifting lower, it will be surprising if we can get to October without some kind of corrective action. But as I've so often said, "the stock market can do anything" and at the moment it is forming a spike, the outcome of which should be quite something to see!



PRIMARY TREND INDEX (PTI): This year I've featured the PTI more than at any time in the past decade. The reason is that I now have more history to show and to work with–and because the PTI is proving to be a most valuable tool in gauging the various trends of the market.

In response to numerous requests, I am publishing this long-term chart of the PTI, covering its action (together with the Dow) from mid-1971 to the present. I believe a careful study of this chart will reveal many interesting things about the market.

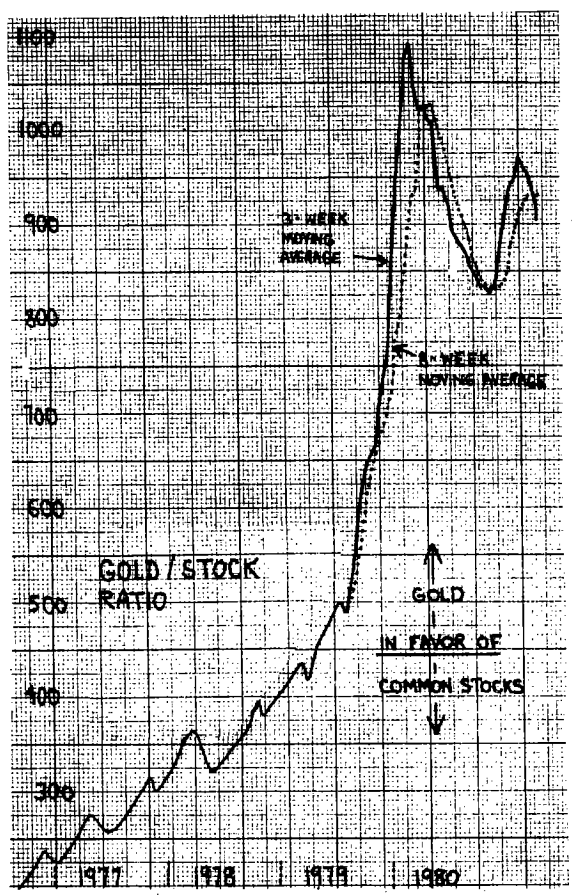
First, note the flagrant nonconfirmation of January, 1973, which saw the Dow rise to its all-time high (1041.40) unconfirmed by the PTI). This was followed by the crash to 577.60 on the Dow and an unbelievable 927 point drop in the PTI.

The PTI turned up in December, 1974 and by early-1975 the PTI had reversed its major downtrend line. The PTI continued up until the 904 peak of 1977. Note that the 904 high on the PTI was not confirmed by the Dow, which had recorded a high of 1014.79 in September, 1976. A violent decline took the PTI down over 200 points to the 1978 low of 688.

From the 1978 low the PTI has advanced on a trend basis, and as of this writing the rising trend from the 1978 low is still intact. Note that at its present level the PTI has pulled quite far away from its basing rising trendline. When it did this during 1978 and again in 1980 a reaction set in, and this is what could be happening now.

However, from a long-term basis, I would say that major (primary) danger would not be signalled until or unless the PTI cracked below the major rising trendline (dotted line) which turned up in 1974.

SWITCH: This chart (below), which I introduced a few years back, is not providing an opinion or a theory. It presents hard facts about relative strength in common stocks compared with gold. What I show here is a RATIO of the NYSE Composite and



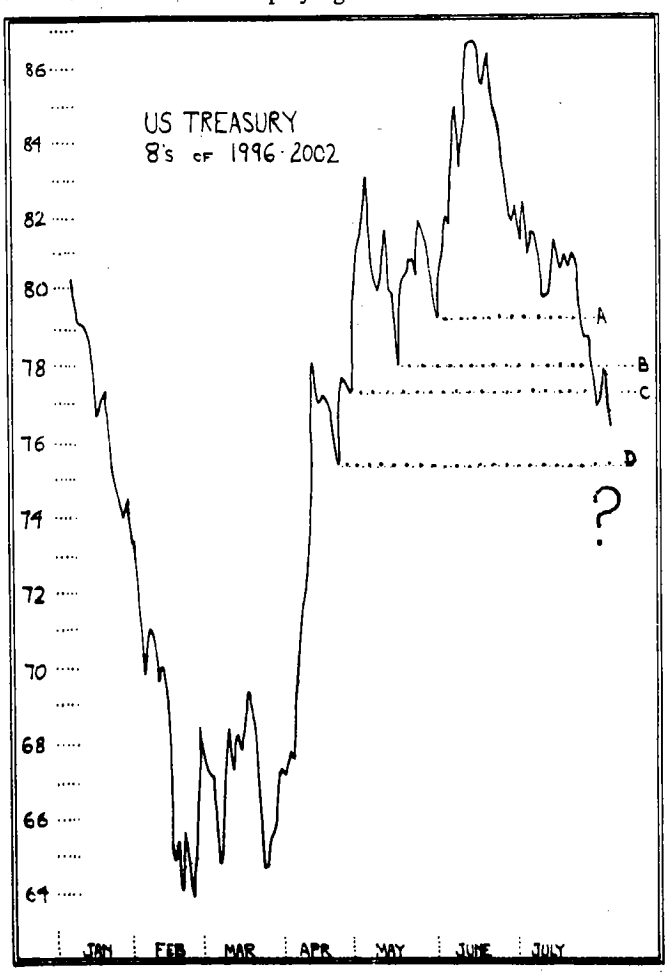
gold (i.e., gold divided by the NYSE Composite) . I arrange the weekly average of this ratio on a 3-week and on an 8-week moving average. A bull relative strength (RS) signal for gold is given when the 3-week MA rises above the 8-week MA. A bull signal for common stocks is given when the 3-week MA breaks below the 8-week MA.

As you can see, gold held sway in relative strength during 1976 to 1980. In February a bull signal was finally given in favor of stocks, and this signal continued in force until May. In May the ratio again signalled that gold was the place to be. But on the week ending July 31 the 3-week MA again plunged below the 8-week MA, and note that this latest signal came at a lower level than the previous signal.

Is this to be a more extended signal for common stock strength over gold? There is no way of knowing, and my suggestion is to let the chart do the talking rather than attempt to outguess the signals. At any rate, the chart is unmistakingly telling us that common stocks are now "in the saddle," that market strength is moving towards common stocks rather than gold, and that for the foreseeable future more money will be made in common stocks than will be made in the yellow metal. That's the market talking, and I've learned never to argue with its verdict.

MONEY, RATES: In Letter 787 (page 4) I included a chart of the Treasury bill futures. The chart showed what I termed "an important head-and-shoulders top in the T-bill futures." My advice in that Letter was, "If you are in any money instruments longer than 91-days, it's 'bye bye time'. Sell them and move into T-bills."

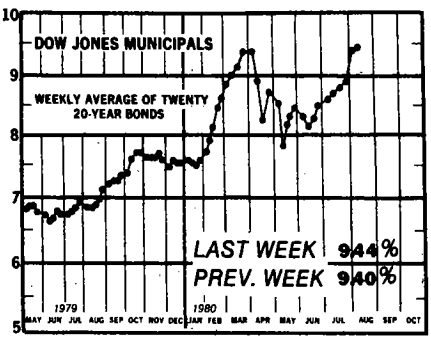
With this Letter I am displaying a chart of the bellwether US



Treasury bond, the 8's of 1996-2002. This bond (like all others) crashed during the opening months of 1980. From a high in the '80's, the bond plunged to a low just under 64 in February. A bottom formed during February-March, following which the bond embarked on an absolutely spectacular advance to just above 86. This resulted in a gain of better than 33% for the bond (which at the February low was also yielding 14%. That's the good news for bondholders (or at least for those who bought near the lows, as suggested in these reports).

As you can see, this bond has traced out a huge top with four levels of support (support labeled A,B,C & D on the chart). On July 28 the bond closed below 79 for the first time since the peak. From there, the deterioration was rapid. On the week ending August 1 the supports at A,B and C were shattered. As this is written, only the final support at D (at the 75 level) remains. And I am not hopeful that this bond will hold above the D level.

My next chart shows the first **historic** damage to be done in this second 1980 run-up in interest rates. Here we see the D-J Municipal Bond yields leaping to 9.4%, the highest level on record! As I've written many times, the Muni's constitute the weakest segment of the money market, and perhaps this tells us something about the inherent strength of our cities, municipalities and states. At any rate, the week ending August 1 saw an incredible rise of .45% in Muni bond rates. What can I add to that performance?

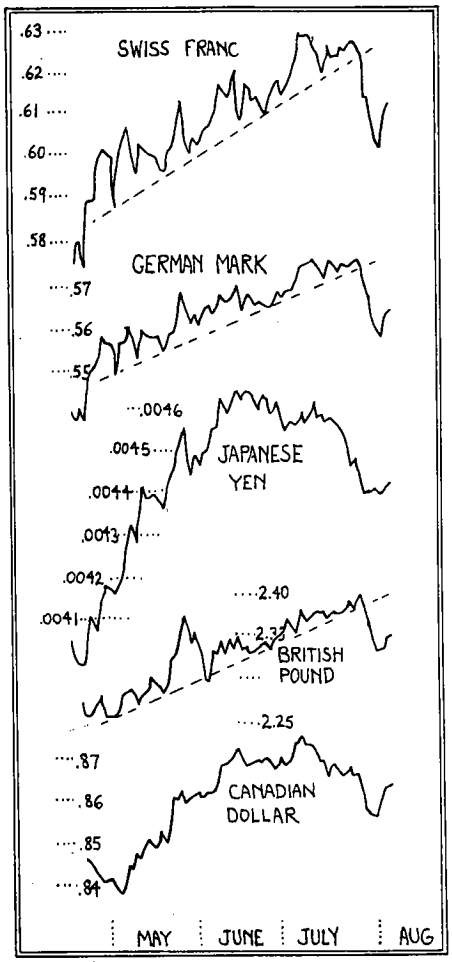


The charts tell me that aside from minor rallies and "hopeful" news events, the bond markets are headed lower and money rates are headed higher. Why? Because the bond market is looking ahead, and it sees debts, deficits and huge US Treasury borrowing. Be guided accordingly, and stay with short term money instruments.

Many investors do not realize it, but short-term interest rates have already risen more than 2.5 percentage points from their 1980 low. Long term bond yields have risen better than 1 percentage point. Thus, those thousands of corporations that had hoped to stretch out their debts in the long-term bond markets have watched in fear and frustration as the days of "lower interest rates" came and went almost before they had realized what had happened.

What are the implications of the rise in interest rates? First, the rise has had a definite firming effect on the dollar, since higher interest rates in the US make the dollar a much more attractive holding. This has led to a sharp decline in most of the foreign currencies (see chart, top of page 5), and it has also put some pressure on gold (which tends to weaken as the dollar strengthens). The rising interest rates also mean that corporations are going to be forced back into the **short-term** money markets for funds (bonds are becoming a dirty word again). Already, many longer term bond offerings are being withdrawn.

Finally, the stronger dollar has brought foreign money into the US stock market since a rising stock market and a strengthening



dollar provides foreigners with a potential "double whammy," the chance of buying US stocks in a rising trend with "cheap dollars" that are rallying against foreign currencies. Whether these foreign equity buyers have been brilliant in their *timing* remains to be seen.

OBSERVATIONS: I've been dealing with investors and investments for 35 years, so I guess I'm entitled to spout some of my philosophy and observations. Anyway, here goes: (1) Making a living solely on the basis of speculation is like running a restaurant. At one time or another, everyone wants to try it. Making money on a restaurant is tough, but making a living solely on your speculative ventures is one of the hardest things I know. Very few members of the NYSE attempt to live exclusively on their trading (although many did in the old days). The reason for the dearth of traders is that pure speculation (especially with present day stock market rules) is difficult, very tough. Despite this, however, many amateurs dream of living entirely off in-and-out trading. In general, my answer to the question of whether you should even attempt to live off speculation is, "No, don't try it, forget it."

(2) If you are fairly well-fixed, say you have $500,000 and up, you CAN live modestly on the *return on your capital* (you should be able to bring in $40 to $50 thousand a year), and you can speculate with a small portion of your capital. It may sound ironic, but often the best *investments* turn out to be the best speculations. By this I mean that I've seen conservative people come in and buy the stock market following a broad panic or a major bear market, and they buy the market because it offers them a great *return on their money*. A few years or later this same person (still conservative) decides that the great investment is now no bargain at market value, simply because the yields have diminished. So the stock is sold and lo–it turns out that the investment at the bottom was a very profitable one (even though it was originally purchased for no other reason but that it offered an excellent return.)

(3) I've noted another phenomenon among conservative investors. Conservatives tend to buy sparingly and hold for long periods. Thus, the fellow who bought 200 shares of Martin at 14 in 1974 may have held it all the way up to today's price of over 40. But the fellow who bought 2000 shares of Martin in 1974 got shaken out when the stock rose from 11 to 19, then broke back to 13 in 1975. From the low, Raytheon advanced to its 56 high without another serious sell-off. The moral: It's far better to make a good profit on 200 shares than to make nothing on 2000 shares!

(4) The trick to investing these days is to avoid big losses. A leading advisor to wealthy investors tells his clients (in view of the seeming perpetual inflation) that he is going to show them "how to lose purchasing power SLOWLY." And he's serious–he's not just being cute. The fact is that the average investor probably does not even retain his purchasing power over a 10-year period. Why is this? Basically, it's because over a 10-year period he is apt to make a few very costly errors and take some large losses.

How do you avoid this? In my opinion, the best way to avoid it is to invest conservatively, stay diversified, never put all your eggs in one basket, and make use of the one redeeming feature of today's markets, and here I'm referring to the consistently high interest rates. If you can bring in 8% to 11% on the bulk of your assets and make one or two good plays a year with say 25% to 50% of your funds, you will stay ahead of the game. But in today's very fast moving, news-oriented markets, the chances of error, panic, miscalculations or fear-inspired mistakes are so high, the investor who is out to "shoot the works" is very likely to lose the works. I've seen it happen over and over again!

(5) I've been asked repeatedly, "Russell, with the PTI pushing to new highs how would you play this stock market?" Personally, the only way I would play it is with leading no-load mutual funds, funds which have switch capabilities (capabilities of switching with a telephone call to daily cash income funds). One of my favorite groups of funds is the fund run by Newberger Berman, 522 Fifth Ave., NYC 10036 (212-790-9800). The no load funds have the advantage of (1) superior management, (2) no commission paid by the buyer, (3) switching to a cash reserve fund and back for a very minimal charge, and (4) complete liquidity in that you can buy or sell large quantities of these funds with no problem of market bid-and-asked spread, lack of orders, thin markets, etc.

GOLD AND THE DOLLAR: The dollar, in my opinion, is going to turn very strong. I say this because US interest rates are heading up. Second, US oil imports are now down 12% over last year–to the lowest level in 5 years. This is going to exert a big plus in the US balance-of-payments (BOP). Americans are continuing to switch to small cars, and thus the level of oil imports is going to drift lower. Third, the US is about to enter a program of shipping massive amounts of arms to our overseas allies. This too is going to help our BOP very considerably. In fact, it would not shock me to see our BOP deficits shrink to almost zero in the coming two or three years.

In view of all this, gold has been doing well as it hovers over 600. In fact, the question might be asked, "With the dollar strong, with our BOP about to improve substantially, why isn't gold breaking?" My answer is still–THE CONTINUED BUILDING U.S. AND WORLD DEBT. For every ounce of new gold that is mined, thousands of dollars and other currencies and credits are being created. Furthermore, if a world recession is developing, we can be sure that free world governments will produce even more credits to try to bail themselves out of a politically ominous mess.

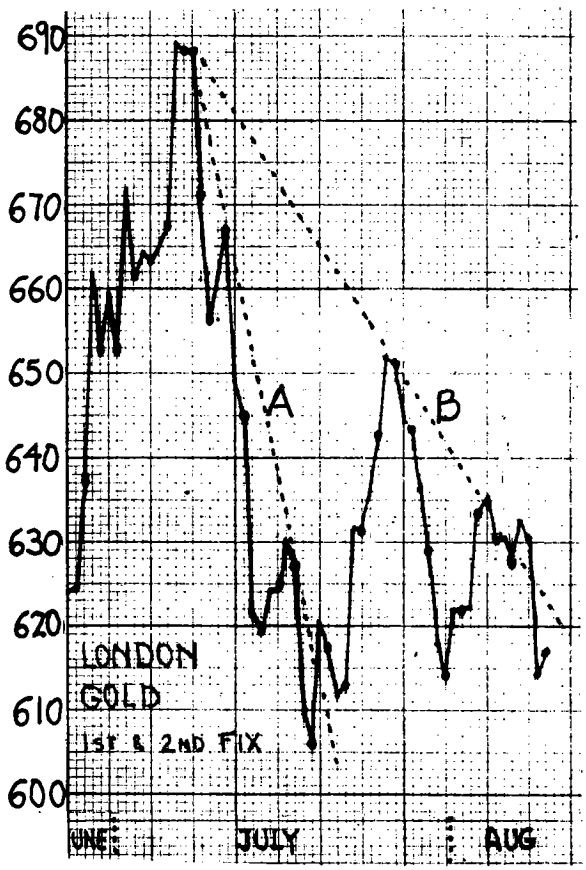
The overall, long-term picture is that far more credits and ultimately paper money are being produced than ounces of gold. Thus, despite temporary runs up and declines, despite weekly and monthly fluctuations, the ultimate target for gold is–much higher.

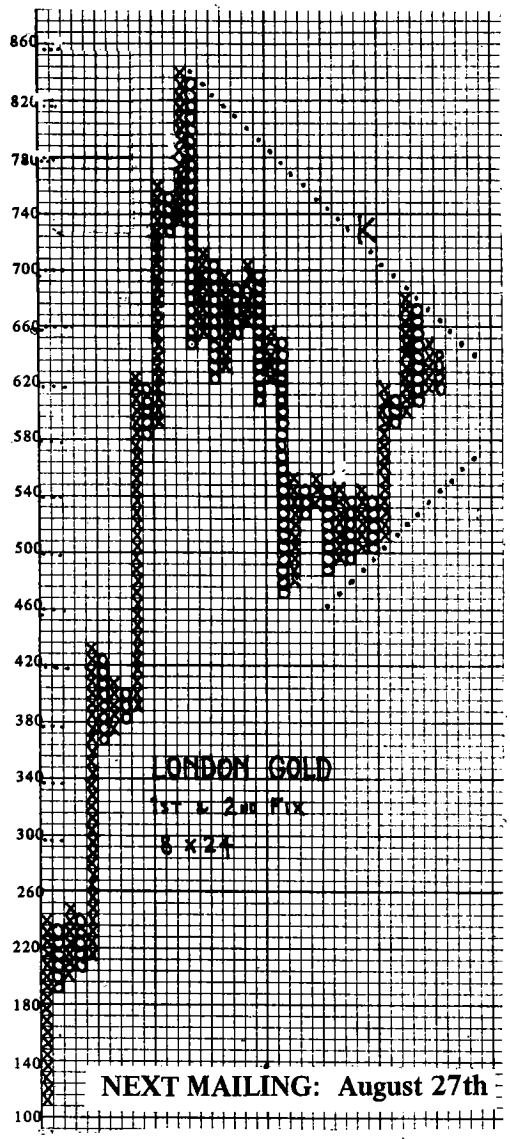
GOLD: I know that most of my readers don't follow the futures market closely, but occasionally I get hints from what is going on in this Vegas of financial worlds. For instance, I know that the total open interest (i.e., the open interest is the number of contracts in force in the futures market) for gold was about 108,000 in early June. This was just prior to the big move in gold from 474 to 688. By the time gold hit 688 in July the open interest had exploded to 170,000 contracts, up almost 60%. Thus, a lot of speculators hopped on the gold bandwagon, and for a while EVERYONE was bullish on gold.

Now everyone can't be right in the markets, and if they try, if too many get on one side of the equation, then the market gets mean, mighty mean. Themeanness was translated in the gold market to a drop from 688 to 606 in late-July. The drop turned a lot of holders in gold futures to poorer and wiser bears. And as of last week I noted that the open interest in gold was down almost 20,000 contracts.

But the important thing is that the price of gold has held above 600 even while thousands of gold contracts were being liquidated. Now no one liquidates his position unless he is bearish, and thus the technical position of gold will strengthen as long as the price tends to hold while the open interest continues to shrink.

I've also been watching the short interest in the four listed gold stocks on the NYSE. These four stocks are ASA, Campbell Red Lake, Dome and Homestake. The short interest (indicative of bearish sentiment) has been rising sharply since May. In May the combined short interest in these four stocks was 160,000 shares. In June it was 221,000 shares. In July it was 311,000. This suggests the same sentiment as does the drop-off in gold futures contracts–skepticism about any forthcoming rise in gold. Technically, this skepticism is a big plus for gold.





The daily chart shows the first and second London fixes for gold from the period of late-June to the present. Following the drop from 688 to 606, gold turned up and in mid-July the price structure broke above the first declining trendline marked A on the chart. A drop to 614 followed, and then a rise to 652. Here a second declining trendline was drawn (B). On August 8 gold broke above this second trendline. I am watching now for the creation of a third declining trendline. These trendlines are termed "fanlines," and usually upon the upward penetration of the **third** fanline a reaction is completed. It will, of course, be important for gold to hold above 600 as the process of fanline-creations goes on. A drop below 600 would mean that a whole new period of consolidation would be needed.

On the point & figure chart we see all the action of gold since 1976. The more gold works sideways (to the right), the lower the main trendline of resistance drops (trendline marked K on chart). At this point, the resistance comes in at roughly 660 for gold. Therefore, I would consider any rally above 660 to be of great bullish importance in the gold picture.

Gold momentum has simmered down and as of last week the 13-week rate of change was 123 (gold is still 23% above its price of 13 weeks ago). The 5-week exponential moving average of gold is 630, the 13-week MA is 611 and the primary or 50-week MA for gold is at a record high of 521.

BEVERLY HILLS has got to be one of the most exotic places on earth. While there we saw a scruffy hippie wearing (would you believe) a genuine Krugerrand. We saw a police car, siren at full scream, smash at 50 mph into (incredibly) an undercover detective's car, both on their way to the same scene! Several bystanders thought the accident was part of a movie. On and near Rodeo Drive we saw the following: metermaids with Gucci bags, shops so exclusive you need an appointment just to enter. The prices in BH are, for the most part, rather wild. Yet in one shoe store I bought four pairs of summer canvas shoes reduced 65% to $10 and $15 a pair! We also had a simply great meal atop the L'ermitage Hotel (guided there by gourmet James Dines). It was absolutely the best dinner I've ever had outside of NYC.